Internal Revenue Service

memorandum

CC:TL-N- 7526-88/7802-88
Brl:CEButterfield

date: SEP 13 1988

to: District Counsel, Cleveland CC:CLE
Attn: Mr. Richard Bloom

from: Director, Tax Litigation Division CC:TL

subject: [redacted] -- Non-docketed status
Deductibility of legal expenses

This responds to two separate inquiries you forwarded from the Examination Division.

ISSUES

1. Whether legal expenses incurred in obtaining cogeneration agreements were expenditures resulting in the creation of assets having a useful life extending beyond the close of the taxable year. 0263-1200

2. Whether these legal expenses may be currently deducted under I.R.C. § 162, or must be capitalized. 0263-1200

3. Whether litigation in Associated Gas Distributors v. F.E.R.C., 824 F.2d 681 (D.C. Cir. 1987), resulted in the creation of an asset having a useful life of more than one year. 0263-1200

4. Whether the legal fees incurred in that litigation may be deducted currently or should be capitalized. 0263-1200

CONCLUSIONS

1. The cogeneration agreements are assets with useful lives extending for the lives of the agreements (ranging from 25 to 45 years).

2. The legal expenses incurred in the creation of these agreements should be capitalized, rather than being deducted currently as an ordinary and necessary business expense.

3. The litigation in Associated Gas Distributors, supra, resulted in a new marketing right for gas companies with a useful life substantially longer than one year.

4. In spite of the favorable result of the litigation, the expenses were incurred as part of the taxpayer's ordinary business, and should not be required to be capitalized.

FACTS

The first inquiry you forwarded to us involved the entry by [redacted]'s operating companies into cogeneration projects, in compliance with the Public Utility Regulatory Policy Act of 1978 (PURPA). The cogeneration agreements convey no property interest to [redacted], only a right to the energy generated by the [redacted] plants in question, each of which was constructed and is owned by parties unrelated to [redacted]'s operating companies (in [redacted] instances by [redacted] and in the [redacted] by a [redacted]). The shortest agreement has a stated life of 29.5 years, the other [redacted] run for the life of the Federal Energy Regulatory Commission (FERC) license -- 45 or 46 years. In obtaining these agreements substantial legal fees were incurred. They were paid by [redacted] to one law firm for services relating to preparation of the agreements, and any related representation. The taxpayer deducted these fees in the years in which they were incurred ([redacted] and [redacted]).

The taxpayer based the current deduction on the argument that [redacted] has no ownership interest in the plants in question, only the right to purchase the electrical output for a specific period of time. Although the agreements convey no immediate property interest, they do allow the right of forclosure to the [redacted] operating companies in the event of default, so that the operating companies can be assured that the capacity of the plants will be available to their customers. Forclosure is only an optional remedy in the event of default, if the defaults are not otherwise cured by the owners of the plants.

The other factual situation you referred for our consideration is the litigation which culminated in Associated Gas Distributors v. F.E.R.C., 824 F.2d 981 (D.C. Cir. 1987). In that case, after long and costly litigation, the gas companies involved were required to make their delivery facilities available to competing gas suppliers in their area. However, they also obtained the right to charge for delivery of gas they did not provide. Essentially, then, the litigation resulted in the creation of a new product which the gas companies could market separately from the sale of gas, i.e., delivery services. The examiner assigned to Southern Indiana Gas and Electric Company (SIGECO), one of the parties to the litigation, has suggested that the legal expenses incurred in this matter should not be currently deducted, as they resulted in the creation of an asset having a life greater than a year, namely the right to sell delivery apart from the sale of gas.

LEGAL ANALYSIS

I.R.C. § 162 creates a general allowance for deductions for ordinary and necessary trade or business expenses. Section 263 disallows deductions for capital expenditures, which are further defined in Treas. Reg. § 1.263(a)-2(a) as expenditures which result in the acquisition of assets with useful lives of more than a year. See also Treas. Reg. § 1.461-1 (a).

That intangible assets may be included in the restrictions of section 263, or its predecessors, has been long established in case law. Sprinks Realty Corp. v. Burnet, 62 F.2d 860 (D.C. Cir. 1932), cert. denied, 290 U.S. 636 (1932). Where an expenditure results in the creation of a separate and distinct asset which has a useful life of more than a year the costs of this creation may not be currently deducted. Commissioner v. Lincoln Savings and Loan Association, 403 U.S. 345 (1971); United States v. Central Texas Savings and Loan Association, 731 F.2d 1181 (5th Cir. 1984). The distinction between a capital expenditure and a current expense has given rise to much litigation. One can find, in the body of case law on the subject, seemingly infinite references to the oblique guidance of Justice Cardozo, that "[t]he standard set up by the statute is not a rule of law; it is rather a way of life. Life in all its fullness must supply the answer to the riddle." Welch v. Helvering, 290 U.S. 111, 115 (1933).

Needless to say, when the proper interpretation of the tax laws requires us to call on life in all its fullness, courts of appeals are bound to disagree. One of the guideposts for separating capital expenditures from ordinary current expenses is the useful life of what is obtained by the expenditure. A strict application of the one year rule, however, is not supported by precedent. As the Court pointed out in Lincoln Savings and Loan, 403 U.S. at 354, "many expenses concededly deductible have prospective effect beyond the taxable year."

Some legal expenses will clearly by incurred on an ongoing basis by any continuing enterprise, and some of these expenses will clearly be currently deductible. It is important that whatever position we take with regard to the fees in these cases does not lead us into the reasoning rejected by the Seventh Circuit in Encyclopaedia Britannica, Inc. v. Commissioner, 685 F.2d 212 (7th Cir. 1982). That case involved the proper treatment of payments to an editor for the creation of a reference volume. Said the court, at 217:

> [i]f one really takes seriously the concept of a capital expenditure as anything that

> yields income, actual or imputed, beyond the period (...) in which the expenditure is made, the result will be to force the capitalization of virtually every business expense. It is a result courts naturally shy away from.... The distinction between recurring and nonrecurring business expenses provides a very crude but perhaps serviceable demarcation between those capital expenditures that can feasibly be capitalized and those that cannot be.

Similarly, the Court in Lincoln Savings and Loan, at 354, based its decision on the creation of "what is essentially a separate and distinct additional asset...." In Iowa-Des Moines Nat. Bank v. Commissioner, 592 F.2d 433 (8th Cir. 1979) the court considered expenses incurred in the acquisition of credit information on bank customers to establish credit card customers, and allowed current deduction, considering the short-lived nature of credit reports, even though they might have utility beyond the close of the year in which acquired. The court stated at 436, "[w]here the prospective benefit is very slight, capitalization is not easily supported."

Also informative is Briarcliff Candy Corporation v. Commissioner, 475 F.2d 775 (2d Cir. 1973), in which the court allowed current deduction of expenses incurred in establishing franchise arrangements for the retail marketing of the company's candy products. The court found the insubstantial nature of the contract rights obtained did not rise to the level of a separate and distinct asset, and that the expenses incurred in obtaining them were to preserve an existing operation. See also NCNB Corp. v. United States, 684 F.2d 285 (4th Cir. 1982); Colorado Springs National Bank v. United States, 505 F.2d 1185 (10th Cir. 1974). (Costs in establishing credit card customers were in preservation and improvement of existing business and income, therefore currently deductible.)

Besides this general guidance on the distinction between capital and ordinary expenditures, there are several cases and publications on the treatment of litigation expenses. The Service has published its position in Rev. Rul. 78-389, 1978-2 C.B. 126. Rev. Rul. 78-389 takes its cue from case law, stating that the test for deductibility of litigation costs lies in the origin and character of the litigation. If the litigation is directly related to the taxpayer's income-producing activities, costs are currently deductible. Kornhauser v. United States, 276 U.S. 145 (1927). If it is related to protection of long term property interests, and only indirectly related to the ongoing operations of the taxpayer, costs must be capitalized.

The device of looking to the origin of the litigation was employed in United States v. Gilmore, 372 U.S. 39 (1963). There the Court stated, at 48, that the deductibility of the fees rested on

> whether or not the claim arises in connection with the taxpayer's profit-seeking activities. It does not depend on the consequences that might result to a taxpayer's income-producing property from a failure to defeat the claim, for ... that "would carry us too far" (footnote omitted) and would not be compatible with the basic lines of expense deductibility drawn by Congress. (Emphasis in original.)

The Court went on to state, at 49, that "the origin and character of the claim with respect to which an expense was incurred, rather than its potential consequences upon the fortunes of the taxpayer, is the controlling basic test ...."

Although the origin and character test in Gilmore was applied to determine whether litigation was related to the business of the taxpayer or was a personal expense, it has since then been applied to make the distinction between ordinary and capital expenditures. Woodward v. Commissioner, 379 U.S. 572 (1970). In Woodward the Court considered a legal proceeding to determine the value of stock under a law requiring majority shareholders to buy out minority holders. The court found that the establishment of value was essentially litigation over purchase price and therefore originated in the acquisition of a capital asset (the stock); thus the legal expenses associated therewith were to be capitalized.

This same test has also been applied more recently by the Ninth Circuit in Madden v. Commissioner, 514 F.2d 1140 (9th Cir. 1975), cert. denied, 424 U.S. 912 (1976). In Madden the court considered deductibility of legal fees paid by taxpayers in an action to oppose condemnation proceedings on their land, which they were using in their orchard business. The court found that the proceeding had its origin in the government's need for the land on which the taxpayers conducted their business, thus related to the sale and acquisition (albeit through forced sale) of the property. Id. at 1151.

The Tax Court has also applied the test in BHA Enterprises, Inc. v. Commissioner, 74 T.C. 593 (1980), acq. in result only, 1982-2 C.B. 1. The Tax Court also expressed approval of Rev. Rul. 78-389. In BHA Enterprises the taxpayer deducted legal

expenses connected with defending an action by the FCC that arose out of allegedly improper practices by the taxpayer, a broadcaster. The court found that the case arose out of the ongoing operation of the taxpayer, and that its defense was necessary to allow the taxpayer to continue in its income producing activity. While the protection of an FCC license was somewhat akin to the protection of title, the court found that the origin of the litigation was in the ongoing business of the taxpayer. In our acquiescense, we point out that the court applied the correct test, but that references to the possible outcome of the case -- revocation of the taxpayer's broadcasting licence -- were misplaced. It is the origin, and not the outcome of the litigation that determines the character of expenses associated therewith. See also PLR 8831001.

It remains to apply these precedents to the two situations you referred to us. We perceive the expense incurred by [redacted] in obtaining cogeneration agreements (and not in the defense or prosecution of litigation) to have given rise to separate and distinct assets. See Commissioner v. Seaboard Finance Co., 367 F.2d 646 (9th Cir 1966) (contracts gave rise to amortizable expenses). These assets are of measurable lives, and of considerably greater significance than those considered and rejected by the courts in Briarcliff and Iowa-Des Moines Nat. Bank. We would therefore recommend capitalization of the expenses. We would also be willing to litigate the issue if the taxpayer will not agree to this treatment, but we would prefer that any test case of the issue be brought in a favorable circuit, such as the Fifth or the Seventh. The Fourth Circuit would probably be the worst one in which to raise a test case.

On the other hand, the litigation at issue in Associated Gas Distributors is governed by the application of the origin and character test. We believe that the litigation had its origin in the ongoing business of the companies involved -- to protect and continue the regular conduct of their business of selling and delivering gas. The fact that these two activities may now be unbundled and sold separately does not alter their essential nature, and besides it goes to the outcome of the litigation and not its origin.

Overall, we would point out that the Service has had limited success in pushing the limits of the capitalization requirements. The list of losses is considerably longer than the list of successes. Therefore we would exercise caution in pursuing any case involving this issue. Judicious choice of circuits is called for, as well as careful screening of the facts. In any case in which the issue could be settled in exchange for valuable concessions from a taxpayer, we would hesitate to recommend litigation. We do believe that [redacted] represents a good vehicle for the issue, because the amounts of legal fees are

substantial, and the assets clearly defined and long-lived. The legal fees in Associated Gas Distributors, however, should be deducted in the years incurred.

If you have any questions with regard to this matter, please do not hesitate to contact Ms. Clare E. Butterfield, at 566-3442 (FTS).

MARLENE GROSS

By: Richard L. Carlisle
RICHARD L. CARLISLE
Senior Technician Reviewer
Branch No. 1
Tax Litigation Division